No. 14737

United States Court of Appeals

FOR THE NINTH CIRCUIT

A. G. Homann, *Petitioner,*

vs.

Commissioner of Internal Revenue, *Respondent.*

Anna Homann, *Petitioner,*

vs.

Commissioner of Internal Revenue, *Respondent.*

PETITIONERS' BRIEF

Harry Ellsworth Foster,
Counsel for Petitioners.

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501 Security Building
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PETITIONERS' BRIEF

HOMANN TAX BRIEF

OPINION BELOW

The Memorandum Findings of Fact and Opinion of the Tax Court (R. 14-26) are not officially reported.

JURISDICTION

Jurisdiction to review decisions of the United States Tax Court is conferred by Section 7482 of the 1954 Internal Revenue Code. These petitions for review involve a de-

ficiency in the income tax for the calendar year 1946 for petitioner A. G. Homann $5,922.70, and for the petitioner Anna Homann, $6,202.04 and are taken from decisions of the Tax Court entered March 1, 1955, (R. 27-28), pursuant to Memorandum Findings of Fact and Opinion (R. 14-26). Taxpayers are husband and wife residing in the state of Washington, a community property state, and filed separate income tax returns for 1946 (R. 15), in the Collector's office in Tacoma, Washington, all within the jurisdiction of this Court. Petitions for Review were filed March 28, 1955 (R. 29-30).

QUESTION PRESENTED

The sole issue is whether the profit realized from the sale of 68 houses in 1946 is taxable as ordinary income or as capital gains under *Section* 117 of the *Internal Revenue Code of* 1939.

STATEMENT OF THE CASE

These consolidated cases (R. 4) involve income tax liability redetermined against petitioners for income tax deficiency for the calendar year 1946. Washington being a community property state, petitioners, husband and wife, filed separate income tax returns (R. 15). Petitioner has been a general contractor for thirty years and in 1944 began the construction of 85 houses at Sunnyside, in Yakima County, Washington, near the Hanford Engineer

Works, at a total cost of $515,539.82, of which amount he borrowed $450,000.00 (R. 17) plus a separate loan of $45,000.00. All houses were rented in 1945 before any sales were consummated (R. 17). All tenancies were month to month with no written leases. Petitioner did agree orally that some tenants might apply the rent on the purchase price in the event of purchase.

The Court found the petitioner had never built any houses on his own account which were sold to others except those in controversy. He has never had a real estate brokers license and never before built houses on his own account for rental. During the year in question, the Court found (R. 18) that all houses were sold to volunteers and that no "For Sale" signs were ever displayed nor were newspaper advertisements carried.

The Court found (R. 19-20) that in 1945 petitioner started the construction of a cannery building in Olympia, Washington for the Midfield Packers at an estimated cost in excess of $200,000.00 and that before completion, the Midfield Packers failed at which time petitioners had between $50,000.00 and $60,000.00 invested in the project. Petitioners filed a lien which was foreclosed, by decree entered September 9, 1949, and affirmed on appeal March 9, 1951 (*Homann v. Huber,* 38 Wash. (2d) 190, 228 P (2d) 466, (R). 20, 53). He completed the building at a

cost of approximately $96,000.00. He still owns the building, the first floor of which is rented to the Olympia Brewing Company at a monthly rental of $1,250.00 and the upper floor to the State of Washington at a monthly rental of $450.00. 16 houses were sold in 1945 and 68 houses were sold in 1946. The Tax Court found that the 68 houses sold in 1946 were held primarily for sale to customers in the ordinary course of the petitioners' business (R. 22).

The taxpayers' original purpose was to rent the employees of the Hanford Engineer Works (R. 45, 81, 105-6, 52). When those employees were moved, a short radio campaign was conducted to rent the houses to others (R. 46) but no mention was made of sale (R. 62).

Prior to the freezing of taxpayers' bank credit, the houses were held for rent, but that plan was changed early in 1946 when the bank denied taxpayers further credit and demanded liquidation of the existing advances at the rate of $5,000.00 a month (R. 105-6). Thus, the sales of the houses were forced (R. 52, 106). It was impossible to sell all of the houses in a single transaction, (R. 100), necessarily resulting in individual sales. The houses were then selling as fast as the renters could be removed (R. 106, 94).

The real estate broker, Mr. Horace L. Miller, was dis-

abled by paralysis and was, therefore, unable to testify (R. 80, 87).

ASSIGNMENT OF ERROR

The Tax Court erred in finding that the 68 houses sold by petitioner during 1946 were held primarily for sale to customers in the ordinary course of business within the meaning of *Section* 117 *of the Internal Revenue Code of* 1939 in that such determination is contrary to the law and not supported by any evidence.

SUMMARY OF ARGUMENT

The profit realized by petitioners on the sale of the 68 houses is taxable as capital gain. This is so for the following reasons:

1. Petitioners' uncontradicted purpose was to own rental property.
2. All of the houses were rented before sale.
3. There was no activity to stimulate sales. All purchasers were volunteers. Houses sold themselves. Broker closed sales at one-half ordinary commission.
4. Taxpayer is a general contractor and devoted his time to that business. Moreover, taxpayers were at all times engaged in the business of renting real property and still are.
5. Taxpayers have no prior or subsequent sales history. Except for the houses in question, none were ever built by the taxpayers for either rental or sale.

6. April 7, 1945, taxpayer began construction on building for concern in Olympia which subsequently failed, tying up $50,000.00 to $60,000.00 of petitioners' capital. Bank loans ranging from $45,000.00 to $60,000.00 were called, necessitating sale of houses. Lien on Olympia building foreclosed, purchased by taxpayers and finished at a cost of $96,000.00. They still own this building which produces rental income of $1,700.00 monthly. The 68 houses which taxpayers hoped to rent were liquidated in order to save the other investment.

The finding that the houses sold by the petitioners in a taxable year were held for sale to customers in the ordinary course of the taxpayers' business is unsupported by the evidence and is contrary to law. Frequency and continuity of sales by themselves do not sustain the finding nor is the inadequacy of the rental income decisive.

ARGUMENT

Scope of Review

At the outset, a brief discussion of the scope of review of factual determinations of the Tax Court is required. *Subdivision (a) of Sections* 7482 *of the* 1954 *Internal Revenue Code* provides that the decision of the Tax Court may be reviewed in the same manner as decisions of the District Courts in civil actions tried without a jury. While the District Court by *Subdivision (a) of Rule* 52 of the *Rules of Civil Procedure* is required to find the facts and separately state its conclusions of law therefrom, the Tax

Court is under no such compulsion but commingles both.

Here upon a partial stipulation of facts and the remainder from undisputed evidence, the Tax Court concluded that the 68 houses sold in 1946 were held primarily "for sale to customers in the ordinary course of petitioners business."

This is contrary to law and unsupported by evidence and therefore clearly erroneous. The only circumstance pointing to that conclusion is that 68 houses were sold in 1946 but it has been determined that frequency and continuity of sales alone does not justify this conclusion.

1. *Lobello v. Dunlop,* 5th Cir. 210 F. 2d 465
2. *Victory Housing v. C. I. R.,* 205 F. 2d 371
3. *Delsing v. U. S.,* 186 F. 2d 59
4. *Goldberg v. C. I. R.,* 223 F. 2d 709

This precise finding in the Goldberg case was predicated upon the sale of 90 houses in 1946. The 5th Circuit reversed the Tax Court (223 F. 2d 711, 712). The conclusion expressed by that Court was that findings induced by an erroneous view of the law are not binding nor are findings combining both fact and law when there is error as to the law.

This Court in *McGah v. Commissioner,* 210 F. 2d 769, held that such a finding was not binding upon the Court of Appeals. The taxpayers showing here is much stronger

and the Court in the McGah case declared that a mistake had been made. Other cases reaching similar conclusions are cited in the McGah and Goldberg cases.

NO OPTIONS

The Court found there were no written leases but that there were oral arrangements which amounted to an option to buy. This conclusion is unwarranted by the evidence because it is a matter of state law and the Supreme Court of Washington has held in an unbroken line of decisions that an oral agreement for the sale of real property is void:

> *Chamberlain v. Abrams,* 36 Wash. 587, 79 Pac. 204;
> *Somers Company v. Pix,* 75 Wash. 233, 134 Pac. 932;
> *Brown v. Kausche,* 98 Wash. 470, 167 Pac. 1075;
> *Pitman v. Smith,* 158 Wash. 467, 291 Pac. 334.

What was petitioners' business?

Primarily, of course, the husband petitioner is a general contractor which requires his full time and energies but for the purpose of this case, however, during the tax year in question and since, the petitioners have also been in the business of renting real property. All of the 85 houses were rented in 1945 and the remaining 68 were rented during 1946 up to the time of sale. Taxpayers have never, either during the tax year in question or since, abandoned the business of owning real property for rent-

al income.

Early in 1946, the bank to whom the taxpayers were indebted between $40,000.00 and $60,000.00, refused further credit and demanded liquidation of the existing indebtedness at the rate of $5,000.00 per month, which necessitated the sale of the houses.

In April of 1945, petitioner started the construction of a building in Olympia, Washington for the Midfield Packers, but the building was uncompleted at the time of the failure of the Midfield Packers when they owed taxpayers between $50,000.00 and $60,000.00 on the building. While the taxpayers had lien rights in that building which subsequently ripened into ownership, they then had no interest in it which could be either sold or hypothecated. Foreclosure ensued and taxpayers purchased the property at the foreclosure sale and subsequently completed the building at an added cost of $96,000.00. Since then it has produced them a monthly rental income of $1,700.00.

Petitioners reside in Olympia while Sunnyside is in the Yakima Valley, approximately 200 miles distant. If all other circumstances were equal, therefore, the rental investment at home was more desirable.

The view of the Tax Court was that the 68 houses in 1946 were held primarily for sale to customers in the

ordinary course of the petitioners' business. It concluded that the holding of the property "during the taxable year" was decisive. But this is entirely erroneous because it forecloses the possibility of capital gains treatment on the profit from the sale of investment real property. After a decision to sell is reached, the rental purpose disappears. .....

Until the bank demanded liquidation of petitioners' outstanding indebtedness, the houses were held for rental and were rented. After that demand, however, they were sold with all possible dispatch and during that time they were held for sale but that did not change petitioners' business. The opinion in the first *McGah* case, 193 F. 2d 662, 663, vacated the general finding and remanded the case for a specific finding. Your Honors there said:

> "The Tax Court found that, at the time of their sale, the 14 houses were held by petitioners primarily for sale to customers in the ordinary course of petitioners' trade or business. There was, however, no finding as to whether the 14 houses were so held prior to their sale, or as to when and how long, if at all, the 14 houses were so held prior to their sale."

Some species of property are susceptible of instantaneous sale or in a single transaction, illustrative of which are listed securities or a building. 68 houses on the other hand must be sold individually and when the change in petitioners circumstances occurred, the sale was made with

dispatch and without sales activity because the houses were selling faster than the renters could be evicted. This view is emphasized in the following passage from the opinion in *Victory Housing No.* 2, 205 F. 2d 371, 373 (10 C. A.):

> "The fact that 42 units were sold over a period of six months does not establish a real estate business or the sale of property in the ordinary course of such a business. If a farmer has twenty separate farms which he used in his farming business and, desiring to quit farming and to dispose of his holdings, sells them in the course of three or four weeks, or three or four months, the fact that there are a considerable number of sales in a relatively short time standing alone is not sufficient to put him in the business of selling farms in the ordinary course of such a business. The same must be said with respect to these 42 units."

A similar conclusion was reached in the 8th Circuit, *Dillon v. C. I. R.,* 213 F 2d 218, 220. The following paragraph in that opinion is quite significant:

> "The Tax Court bases its determination upon the ground that "We must determine the purpose for which the property is held during the taxable year (1946) in question," and that after October 15, 1945, "the 20 houses in question were held primarily for sale to customers in the ordinary course of business in the taxable year and net profits . . . are taxable as ordinary income." The 20 houses were sold during the period from January 1, 1946, to August 8, 1946. The Court arrives at its conclusion on this point by a consideration of the business done in the taxable year 1946, and attaches no significance to the

resolution of the taxpayer to liquidate his holdings in the houses in the fall of 1945. The Court cites one of its own opinions only to support its theory. Strictly applying this rule had the taxpayer decided to liquidate his holdings in December, 1945, and failed to complete the liquidation before January, 1946, the result would have been the same. Neither a statute nor the decision of any court is cited to support the theory of the Tax Court. We think the principle applied is neither legal nor reasonable, but that it is clearly erroneous. Under the evidence here the petitioner was not in the real estate business in Omaha in 1946. He was liquidating his ownership of 20 houses through a corporation engaged in the real estate business. There is no conflict in the evidence on this decisive point."

And, significantly, the 5th Circuit in *Goldberg v. C. I. R.*, 223 F. 2d, 709, 712 said:

"The frequency and continuity of sales is also important. If a rental corporation's assets are sold in a single transaction to a single purchaser, it could not be reasonably contended that there was a sale to a customer in the regular course of business. But more often the owner sells his rental properties piecemeal to different individuals. How frequent the sales are depends on many circumstances; the extent to which the seller turns his talents to the promotion and solicitation of sales, the number of units in the rental project, and the state of the market. Only the first of these circumstances has any rational connection with the question whether the owner has changed his business to selling, or is simply liquidating his business. Thus the frequency and continuity of sales factor is significant only so far as it reasonably justifies the conclusion that the owner somehow promoted the sales. The courts do not deny capital gain bene-

> fits simply because a large number of sales are made in a short period; for if the owner has a large number of houses on a seller's market, it is quite possible that he may sell them continuously without any sales promotion or solicitation."

A like conclusion was reached in *McGah v. Commissioner,* 210 F. 2d 769.

Of course, the primary business of the petitioner, A. G. Homann, was that of a general contractor, but for the purposes of this case he was also in the business of renting real property and that business never changed. While he had houses for rent in 1946, since then he has had a building for rent. It must be conceded that during the time the houses were rented that they constituted real property used in the taxpayers rental business as was said in *Victory Housing No. 2 v. C. I. R.,* 205 F. 2d 371, 372:

> "In order then to uphold the finding and judgment of the Tax Court, there must be evidence supporting a finding that petitioner changed the nature of its business or enlarged its business so as to include therein not only its rental business but a general real estate business and that it placed these capital assets into its real estate business and thereafter disposed of them in the usual course of such business."

The Tax Court placed undue emphasis upon the disparity between the rental income and the sales income (R. 21-22). The rental income in 1945 was only $4,892.85, while the sales income was $10,346.43 and the rental ex-

penses exceeded $9,600.00 and that in 1946, the income from rents showed a loss of $1,034.25 while the income from sales was in excess of $20,000.00. But that overlooks the fact completely that since the liquidation of the housing investment and the acquisition of the Olympia building investment this was completely reversed with no sales income at all and a rental income of $1,700.00 monthly or an annual rental income of $20,400.00.

Taxpayer testified that his purpose was to acquire rental property at the time he built the houses. It was impossible for him to hold the houses for that purpose for reasons already detailed, but after the liquidation of those houses, he acquired another asset which fulfills his original aim in consequence of which he is still in the rental business and successfully so.

The reason which prompted Congress to enact the Capital Gains Provision in *Section* 117 (*j*) *of the* 1939 *Internal Revenue Code,* was that the profit realized upon sales resulting from an increase in value during the time property was held for investment was properly taxed as capital gain as opposed to ordinary income resulting from sales to customers in the ordinary course of the taxpayers business.

The disparity between the rental income and the sales income is not controlling. In *Delsing v. U. S.,* 186 F (2d)

59, 61, the Court of Appeals in the Fifth Circuit declared:

> "The disparity between income from sales and from rentals is not controlling. Under the facts and circumstances of this case, we find no permissible basis for a determination that the sales of the originally constructed defense rental housing units constituted a disposition of 'property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,' so as to render the profit taxable as ordinary income.
>
> "We think the transactions evidenced the sale of capital assets and that accordingly the judgment must be, and is, reversed and the cause remanded with direction to enter judgment in favor of the taxpayer for the amount of refund claimed."

And, more recently, in the *Goldberg v. C. I. R.,* 223 F. 2d 709-713, reiterated the same view in this sentence:

> "The fact that the rental business had been unprofitable, to which the Tax Court attached such significance, is fully as consistent with a decision to liquidate the property opportunely, as to turn it into another more profitable type of business."

The liquidation of an investment unaccompanied by any considerable sales activity results in capital gain.

Dillon v. C. I. R., 213 F. 2d 218
Goldberg v. Commissioner, 223 F. 2d 709
Victory Housing No. 2 v. C. I. R., 205 F. 2d 371
U. S. v. Robinson, 129 F. 2d 297
Farley v. C. I. R., 7 T. C. 198

The Tax Court considered of controlling importance

the volume of the taxpayers sales (68) during the tax year 1946 in determining that such sales were made to customers in the ordinary course of the taxpayers business, but this view is erroneous. It was answered in the Goldberg case, 223 F. 2d 709, 713, in the following paragraph:

> "(3) In short, the only evidence that the corporation was engaged in the business of selling real estate was the frequency and continuity of sales, and this for a comparatively short time. Under the circumstances, the fact was equivocal, and that fact alone is not sufficient to support a finding of the ultimate fact that Pinecrest was engaged in selling houses as a business. We conclude that the Tax Court's finding was based upon an erroneous application of the law. Lobello v. Dunlap, 5 Cir., 210 F. 2d 465; Dunlap v. Oldham Lumber Co., 5 Cir., 178 F 2d 781; United States v. Robinson, 5 Cir., 129 F. 2d 297; Victory Housing No. 2 v. Commissioner, 10 Cir., 205 F. 2d 371."

CONCLUSION

For the reason stated, the decision of the Tax Court that the 68 houses were held by petitioners for sale to customers in the ordinary course of taxpayers' business is erroneous and should be reversed.

Respectfully submitted,

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APPENDIX A

Sec. 117. CAPITAL GAINS AND LOSSES

(a) Definitions.—As used in this chapter—

(1) Capital Assets. — The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business, but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(B) Property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), or real property used in his trade or business;

(C) a copyright; a literary, musical or artistic composition; or similar property; held by—

(i) a taxpayer whose personal efforts created such property, or

(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part

by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * *

(j) Gains and Losses from Inventory Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) Definition of property used in the trade or business.—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or C . . .